No. 22023

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

RUDOLPH L. GROSS and CATHERINE D. GROSS,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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I N D E X

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Cases:

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 23-35)[1] are not officially reported.

JURISDICTION

This petition for review (I-R. 37-39) involves federal income taxes for the taxable years 1958 and 1961. On May 20, 1965, the Commissioner of Internal Revenue mailed to the taxpayers a notice of deficiency, asserting deficiencies in income tax in the aggregate amount of $25,388.16. (I-R. 4-8.)[2] Within 90 days thereafter, on

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1/ "I-R." and "II-R." references are to volumes I and II of the record on review.

2/ This amount includes a deficiency asserted for the year 1960 in the amount of $1,686.81 which was paid by the taxpayers and is not in issue here. (I-R. 23.)

August 17, 1965[3], the taxpayers mailed a petition (I-R. 1-9) to the Tax Court for a redetermination of the deficiencies asserted for the taxable years 1958 and 1961 under the provisions of Section 6213 of the Internal Revenue Code of 1954. The decision of the Tax Court was entered on February 16, 1967. (I-R. 36.) This case is brought to this Court by petition for review mailed on May 16, 1967 (I-R. 37-39) within the three month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Whether the Tax Court correctly ruled, on the facts of record, that taxpayers' losses from the nonrepayment of loans were not proximately related to any trade or business conducted by taxpayers as individuals and, hence, qualified only for the limited deduction for nonbusiness bad debts provided by Section 166 of the Internal Revenue Code of 1954.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

> SEC. 166 [As amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606]. BAD DEBTS.
>
> (a) General Rule.--
>
> (1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxab year.

3/ Under Section 7502 of the Internal Revenue Code of 1954, mailing is treated as timely filing.

(2) Partially worthless debts.--When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * *

(d) Nonbusiness Debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * *

(26 U.S.C. 1964 ed., Sec. 166.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.166-5 Nonbusiness debts.

* * *

(b) Nonbusiness debt defined. For purposes of section 166 and this section, a nonbusiness debt is any debt other than--

* * *

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

> The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct in the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). § 1.165-5, relating to losses on worthless securities.
>
> * * *

(26 C.F.R., Sec. 1.166-5.)

STATEMENT

The facts as found by the Tax Court may be stated as follows:

Rudolph L. Gross and Catherine D. Gross are husband and wife and they reside in Portland, Oregon. Taxpayers filed their income tax returns for the periods here involved with the District Director of Internal Revenue at Portland. (I-R. 24.)

Rudolph L. Gross had some experience prior to World War II working for finance companies making consumer loans. After his discharge from the Navy in October 1945 he went to work for the United States National Bank in Portland in the Consumer Finance Department. In 1947 he left the bank and he and a man named White organized a company called Aero Credit Corporation engaged in the business of automotive and airplane financing. There were about 10 to 20 stockholders in this corporation. (I-R. 24.) In 1950

Gross decided to sell out his interest in the above corporation and organize a finance company in which he would be a larger owner. Accordingly, in 1950 he sold his stock interest in Aero Credit Corporation and that year he and Burt Wilson organized the Union Finance Company (hereinafter sometimes called Union), which was formed pursuant to the Oregon Small Loan laws and it engaged in the automobile financing business. (I-R. 24-25.) The parties subscribed and paid for the capital stock of the said corporation as follows (I-R. 25):

Burt Wilson	$ 30,000
Rudolph L. Gross	15,000
Catherine D. Gross	15,000
	$ 60,000

Wilson was not interested in operating the finance company as he was steadily employed as a manager of another firm in Portland, so Rudolph L. Gross was the managing officer of Union. In his income tax returns for the years 1959, 1960 and 1961 he reported salary received from the company in the respective amounts of $24,000, $24,000 and $21,600. (I-R. 25.)

The Union Finance Company derived much of its financing by loans from the U.S. National Bank of Oregon at Portland, to which it discounted customers' contracts at a lower rate of interest than it charged the customers. From its inception, Union's stockholders made advances to the corporation and they were treated as loans and Union executed notes therefor bearing 8 percent or 10 percent interest but all such notes were subject to subordination agreements executed between the payees and the bank subordinating such notes to stockholders to the bank's loans. However, the stockholders' advances permitted the bank to enlarge the line of credit to Union. (I-R. 25.)

It is stipulated that of the $69,880.47 claimed as bad debt deductions on their 1961 income tax return the sum of $55,000 represented advances to Union and that Catherine Gross had advanced $15,000 of said sum from her own funds which she had inherited and Rudolph had advanced the balance. The notes were subject to subordination agreements to the bank. (I-R. 25-26.)

Paragraph 4 of the stipulation of facts provides as follows (I-R. 16, 26):

> 4. Petitioners claimed the following advances as business bad debts in their income tax return for the taxable year 1961:

Name	Amount
Chester March	$ 775.00
Jack Finley	240.00
Ros Morrison	8,884.73
Finley Steel Erectors, Inc.	2,165.44
North Bend Veneer, Inc.	2,815.30
Union Finance Company	55,000.00
	$ 69,880.47

The Commissioner determined that advances to the Union Finance Company were nonbusiness bad debts which did not become worthless until 1962 and the other advances totaling $14,880.17 were nonbusiness bad debts in 1961, the deduction thereof being limited by Sections 1211 and 1212, 1954 Code, to $1,444.33. (I-R. 26.)

Burt Wilson died in 1954 and his son and daughter-in-law, Mr. and Mrs. Gordon Wilson, inherited his interests. Union lost some $69,000 in 1958 and it made only $1,104.23 in 1959. It again lost in 1960 over $66,000 and dissension developed between Gross and Gordon Wilson. In May of 1961 Gordon tried to get Gross to

resign from Union but Gross refused. A certified public accountant was engaged by the corporation in June of 1961 to examine its affairs. The accountant's report, which was not certified, showed Union owed the United States National Bank $929,915.30 secured by notes, contracts and trust receipts due Union from its customers and also by the stockholders' subordinated notes. The report contains an analysis of the pledged collateral, and, with the assistance of management, some attempt was made to evaluate many items of the security given. The indication in the report is that the pledged collateral did not adequately secure the bank obligations. (I-R. 26-27.)

On or about October 19, 1961, Gordon Wilson filed suit against Rudolph L. Gross and Union Finance Company, seeking a receivership, accounting and injunction. Supporting said complaint, Wilson, by affidavit, swore, "The bank is now threatening to foreclose on the security it holds, that the financial condition of the corporation is in grave doubt." (I-R. 27.)

In connection with said lawsuit, a receiver was appointed who thereafter excluded Gross from occupancy of the premises of Union Finance Company. (I-R. 27.)

Union's income tax return for 1961 shows a loss of $155,910.23 and as of December 31, 1961, the balance sheet of Union Finance Company showed a deficit of $51,014.32, computed as follows (I-R. 27):

Assets	$ 835,028.31
Liabilities	$ 826,042.63
Capital stock	60,000.00
Earned Surplus	(51,014.32)
	$ 835,028.31

The United States National Bank continued extending the line of credit to the receiver, who continued to conduct the day-to-day operations of the company. (I-R. 27.)

On June 4, 1962, the bank discontinued its line of credit to the corporation, which action precipitated the receiver's recommendation to proceed with a bankruptcy reorganization or liquidate. (I-R. 27-28.)

On June 18, 1962, the court ordered the corporation liquidated and, by December 21, 1962, its assets had been sold. (I-R. 28.)

With their joint income tax returns for 1960 and 1961 taxpayers filed Schedule 1040C purporting to show an independent business of Rudolph L. Gross of "Loans", with the business address the same as Union or his home. In the schedule for 1960 there is the report, without any itemization, of interest received in the total sum of $3,862.39 and bad debts in the total sum of $5,506.70 and the computation of loss from the purported business of $1,644.31. In the said Schedule C for 1961, again, without any itemization, there is reported interest received in 1961 in the sum of $3,696.96 and bad debts in the sum of $69,880.47 and the resulting loss of $66,183.51. The returns were made out by the

certified public accountant who was also the accountant for Union and had made the audit of Union in the summer of 1961. The return for 1960 appears to be undated but it is stamped received in the District Director's office at Portland on May 8, 1961. (I-R. 28.)

During the year 1961 Rudolph Gross was the holder of 3 unpaid notes representing loans he had made to the makers. One note was an unsecured note signed by Ros and Thelma Morrison. It was dated January 26, 1961, and in the amount of $8,900, with interest at the rate of 8 percent. Morrison was a used car dealer and long-time customer of Union to which he owed money. The loan was to enable Ros to pay off another finance company and thus make the position of Union more solid. (I-R. 28.)

Another note was an unsecured demand note signed by Sam Osmundson for $500, with interest at 6 percent, dated August 31, 1961. Osmundson had been an employee of a customer of Union engaged in the used car business and he wanted to go into business for himself. The loan was made in order to secure Osmundson as a customer for Union but it did not work out as he absconded shortly thereafter. (I-R. 28-29.)

The third note was a note for $4,000, dated January 29, 1959, signed by F. Donald and Rosemary K. Windsor payable $2,000 on January 29, 1960, and $2,000 on January 29, 1961, with interest at 7 percent. The note was secured by a mortgage executed by the Windsors on their home. (I-R. 29.)

Taxpayer Rudolph Gross had loaned money in years prior to 1961 to other individuals on their promissory notes. He loaned $2,720.5 to Peter LaLonde on a note executed by Peter and his wife Delora M. dated September 7, 1956, with interest at 10 percent per annum after maturity and the note was made payable in 24 monthly installments. The note was paid in full. (I-R. 29.)

Another such note is a $35, 30-day, 6 percent note signed by Frank G. Patterson which is dated November 22, 1960, and it is marked paid. (I-R. 29.)

Gross made some other advancements or payments that are represented here by his canceled checks to Arthur Lehman, Clarence and Buelah Clinton, Mary Bergdorf, Harold Keller, Gerald and Lueen Smith, L. W. Taylor, Michael P. O'Brien, Baby Furniture, Inc., North Bend Veneer Company, Hitch Hiker Company, Finley Steel Erectors, Inc., Jack Finley, C. H. March, Fred Marks, Alpha Auto Sales and C. D. Kamp. The dates on the checks range from 1957 to 1962 and some of them bear the legend "loan". The checks were generally to customers of Union or to other corporations in which Gross had a substantial stock interest. There is also Gross' canceled check to Union Finance Company dated March 7, 1958, bearing the legend "Loan to Union Finance." Taxpayers amended their petition at the trial to seek an increased business bad debt deduction in 1961 in the amount of approximately

$30,000, based on the foregoing payments or advancements, represented by his canceled checks, being loans and some of them becoming worthless in 1961, and therefore business bad debts. (I-R. 29-30.)

On their income tax returns for the taxable year 1961, the taxpayers claimed business bad debt deductions in the total amount of $69,880.47. (I-R. 23-24.) The Commissioner in his statutory notice of deficiency (I-R. 4-8) disallowed the claimed deductions in their entirety. The taxpayers filed a petition with the Tax Court for a redetermination of the deficiencies asserted by the Commissioner. (I-R. 1-8.) The Tax Court denied the taxpayers' claimed business bad debt deductions in their entirety. (I-R. 35.) From that action the taxpayers have filed and prosecuted the instant petition for review. (I-R. 37-39.)

SUMMARY OF ARGUMENT

The question is whether the losses which taxpayer sustained from the nonrepayment of advances to his finance corporation and its customers were fully deductible as business bad debts, incurred in a business or businesses conducted by him individually, or were deductible only as nonbusiness bad debts incurred in aiding the corporation's business and protecting his investment therein. Taxpayer contends that the losses were incurred in his separate business or businesses of money-lending, promoting and financing corporations, and rendering services for pay as a salaried officer of his corporation.

The record amply and affirmatively warrants the Tax Court's findings that taxpayer was not engaged in a separate business of money-lending or of promoting and financing corporations; that his advances were not made to protect his employment; and that, in fact, his advances were made as a stockholder to aid the corporate business and protect and enhance his investment.

Taxpayer's money-lending activities were confined, save in a few instances, to advances to his finance corporation and its customers and ceased when the corporation went into receivership. Taxpayer himself testified that all his advances to individuals were made to secure new customers or strengthen existing customers of the finance corporation; and, generally, that his advances to both the corporation and its customers were made to protect his investment in the former while earning interest. He did not testify, nor is there a scintilla of evidence to show, that he made advances to protect his employment. And as for interest, he failed to show that his advances to customers were interest-bearing The few advances he made to enterprises other than his finance corporation were to ventures in which he also had an investment to protect.

The Tax Court applied the proper criteria, under decisions of this Court and other appellate courts, in ruling that taxpayer's losses were from nonbusiness bad debts, and its decision should be affirmed.

ARGUMENT

THE TAX COURT WAS AMPLY WARRANTED BY THE RECORD IN RULING THAT TAXPAYERS' LOSSES FROM THE NONREPAYMENT OF LOANS WERE NOT PROXIMATELY RELATED TO ANY TRADE OR BUSINESS CONDUCTED BY TAXPAYERS AS INDIVIDUALS AND, HENCE, THAT SUCH LOSSES QUALIFIED ONLY FOR THE LIMITED DEDUCTION FOR NONBUSINESS BAD DEBTS PROVIDED BY SECTION 166 OF THE 1954 CODE

A. Introduction.

Section 166 of the Internal Revenue Code of 1954, supra, authorizes the deduction of bad debt losses. There is no limitation on the right of corporations to deduct all worthless debts in computing taxable ordinary income. This right is also conferred on individual taxpayers with respect to business bad debts. But with respect to individuals' nonbusiness bad debts, Section 166(d)(1) authorizes only a short-term capital loss deduction.[4/]

Section 166(d)(2) defines a nonbusiness debt as any debt other than "a debt created or acquired * * * in connection with a trade or business of the [individual] taxpayer," or "a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business." The underlying provisions of Treasury Regulations on Income Tax (1954 Code), set forth in Section 1.166-5(b), supra, provide in pertinent part that:

> The question whether a debt is a nonbusiness debt is a question of fact in each particular case. * * * the character of the debt is to be determined by the relation which the loss resulting from the debt's

4/ Under Section 1211(b) of the Code short-term capital losses are deductible only to the extent of capital gains plus $1,000 of ordinary income. However, any remaining losses may be carried over for the next five taxable years, as provided in Section 1212 of the Code.

> becoming worthless bears to the trade or business of the [individual] taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, * * *.

In short, an individual taxpayer is entitled only to a short-term capital loss deduction unless he shows that he has sustained a bad debt loss in a trade or business which he has conducted as an individual. And such a loss is not incurred in an individual's trade or business unless it is proximately related to such trade or business. Section 1.166-5(b)(2), supra; United States v. Keeler, 308 F. 2d 424 (C.A. 9th); Weddle v. Commissioner, 325 F. 2d 849 (C.A. 2d). Whether a particular loss or expense is incurred in a taxpayer's trade or business is a question of fact in each particular case, subject to statutory criteria. Lundgreen v. Commissioner, 376 F. 2d 623 (C.A. 9th).

In the case at bar taxpayers contend (Br. 18-24) that they sustained fully-deductible business bad debt losses from the nonrepayment of loans which were proximately related to one or another of three businesses which, it is alleged, the taxpayer Rudolph L. Gross (hereinafter "the taxpayer" 5/) conducted as an individual: (1) A business of loaning money; (2) A business of

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5/ There is nothing in the record to indicate, nor do taxpayers contend on appeal, that the taxpayer Catherine D. Gross, Rudolph's wife, was engaged in any trade or business during the taxable years. Thus references hereinafter to "the taxpayer" relate both to the alleged individual businesses and to the contentions raised by husband and wife on appeal. As noted by the Tax Court (I-R. 32), the single loan made by the wife ($15,000 to Union Finance) was properly treated, in any event, as a non-business bad debt.

financing and promoting corporations for gain; and (3) A business of being a corporate employee.[6]

In weighing these contentions it should be noted, at the outset, that the courts are in general agreement as to the tests for determining whether an individual's activities constitute a separate trade or business for tax purposes. The individual taxpayer must be regularly and actively engaged in activities from which he hopes and intends to realize a profit. Hirsch v. Commissioner, 315 F. 2d 731 (C.A. 9th); United States v. Henderson, 375 F. 2d 36 (C.A. 5th), certiorari denied, November 14, 1967 (36 U.S. Law Week 3200). Moreover, because the business of a corporation is distinct from that of its shareholders, a shareholder's services to his corporation do not necessarily constitute a separate trade or business. "Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. * * * investing is not a trade or business and the return to the taxpayer though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation." Whipple v. Commissioner, 373 U.S. 193, 202.

Finally, in order to claim a business bad debt deduction under Section 166, the individual taxpayer must establish not only that he

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6/ For the purposes of this appeal, it is assumed, as the Tax Court was inclined to conclude (I-R. 30), that the loans to the corporation became worthless in 1961.

is in a trade or business but that the bad debt losses were proximately related to that business. Whipple v. Commissioner, supra, p. 202; Weddle v. Commissioner, supra.

In Hirsch v. Commissioner, supra, having held that the individual taxpayer involved had failed to prove that he had incurred bad debt losses in his own trade or business, this Court emphasized in closing that (p. 738):

> This Court has repeatedly stated the fundamental rule that in reviewing a decision of the Tax Court, the Court of Appeals is "not accorded the right to retry the issues de novo on the record and we must affirm unless the Tax Court decision was arrived at through plain error. * * * To reverse [a decision of the Tax Court] we must find that it is clearly erroneous, in other words, that the taxpayer's evidence so clearly showed the Commissioner to be wrong that the decision in the Commissioner's favor was palpably in error." Young v. C.I.R., supra. [268 F. 2d 245].

In the case at bar, we submit, the Tax Court was amply warranted by the record in ruling that the taxpayer's bad debt losses were not proximately related to any trade or business conducted by the taxpayer as an individual and, hence, were deductible only to the limited extent permitted in the case of nonbusiness bad debts.

B. The Tax Court correctly found that the bad debt losses were not incurred in a loan business conducted by the taxpayer as an individual

Taxpayer contends (Br. 21) that from 1955 to 1961 he was "a money-lender for his own account," and that his bad debt losses in 1961 were incurred in his separate loan business. The record does not bear him out.

From 1950, when Union Finance Company was organized, through most of 1961, taxpayer was a stockholder and the managing officer of the corporation. (I-R. 24-27.) During the period from 1955 to 1962, taxpayer advanced a total of about $130,000 to about 25 individual and corporate parties. (I-R. 32.) Save for the advances to Union Finance and a few individuals, which were reflected in notes, the only evidence in the record of the claimed advances to the other individual and corporate parties consists of canceled checks, some bearing the legend "loan" and some not. The payees of these checks were generally either customers of Union Finance or other corporations in which taxpayer had a substantial stock interest. (I-R. 25, 28-30.) The bulk of the bad debts claimed on taxpayer's 1961 return consisted of advances to Union Finance. (I-R. 26.)

We submit that the Tax Court correctly found (I-R. 32-34) that in 1961 taxpayer was not in a private money-lending business separate from Union Finance's money-lending business. Commonsense tests for determining whether a stockholder has advanced money to his corporation in the course of a private money-lending business are set forth in United States v. Henderson, supra. There the Fifth Circuit, in rejecting such a contention, concluded (375 F. 2d, p. 41) that "the indicia of a genuine loan business were absent," citing inter alia the facts that: (1) Aside from the taxpayer's loans to her corporation, only one was interest-bearing; (2) Neither taxpayer nor any employee of hers devoted a

significant amount of time to making or servicing the loans; (3) Taxpayer did not treat her lending activities as a separate business by maintaining separate books of account or a separate office, or by advertising; and (4) Most of the loans were to social or business acquaintances.

In short, the Fifth Circuit assessed the claimed business activities in terms of substantiality, profit motive and, in general, the usual hallmarks of a genuine commercial enterprise. This Court, too, has stressed the importance of substantiality and a profit motive. Hirsch v. Commissioner, 315 F. 2d 731.

In the case at bar, it is evident on all counts that the taxpayer was not engaged in a private business of lending money to the general public for a profit. The bulk of his advances were to Union Finance or customers of Union Finance, and most of the other advances were to corporations in which he had a substantial stock interest. Moreover, 25 lending transactions over a five or six year period cannot be equated with a regular and substantial line of activities.

Nor does the record show that taxpayer conducted his lending activities as a genuine commercial enterprise, for a profit and with the appropriate separate records and accounts. During the years in question, only a few of the advances to parties other than Union Finance were reflected in interest-bearing notes. (I-R. 32.) As to the rest of the advances, reflected in canceled

checks, there was no clear evidence that any interest was charged; indeed, taxpayer's memory of these transactions was extremely vague. He could remember nothing about some and could only hazard a guess as to the amount due him. (I-R. 33.)

In his returns for the years 1958-1961, taxpayer reported interest income ranging from about $3,700 to $6,900 per year. However, the interest of his loans to Union Finance would account for most of these sums. (I-R. 33.) The interest reported for 1960 and 1961 was substantially exceeded by the claimed bad debt losses. (I-R. 28.)

In almost every instance, the advances to parties other than Union Finance were to substantial customers of Union Finance who were in financial distress. The few advances to corporations other than Union Finance in which taxpayer was a stockholder would appear to be advances of equity capital rather than loans, and even if they were loans, they would appear to be made to enhance or protect an existing investment. (I-R. 33.)

The taxpayer's own testimony as to the manner in which the advances were handled is indicative of the absence of business-like arm's-length dealing (II-R. 101-102):

> Q. Almost all of the transactions we were talking about yesterday, your own private transactions, are evidenced only by a check.
>
> A. That is correct.

Q. Occasionally there is a note but primarily they are checks?

A. That's true.

Q. You have been in this business for a long time. Now, how is it that you didn't take a note or any security in these transactions generally?

A. Well, I knew all these people pretty well and they said I will pay you back so I said O.K. and I gave them a check to help them out.

Q. Now did you know when there was no note how much interest you would get?

A. How did I know?

Q. Yes.

A. When I got the money back I would say you owe me interest for this amount.

Q. How much would that interest be?

A. Well, we would agree upon it at the time.

In sum, the record falls far short of showing that taxpayer was in a separate business of money-lending in 1961 or any other year; rather, it appears quite clearly, as the Tax Court concluded (I-R. 33), that the great majority of his advances were made as a stockholder in Union Finance and other enterprises, to enhance or protect an existing investment. Indeed, taxpayer himself concedes on brief (p. 22) that "virtually all the largers loans" were made to secure new customers for Union Finance or to strengthen the position of existing customers, sometimes to insure repayment of their loans to the corporation. Such advances were obviously in aid of the corporation's business and good will.

This Court's recent decision in Lundgreen v. Commissioner, 376 F. 2d 623, provides a useful contrast. There the court held inter alia on undisputed facts that the taxpayer's bad debt losses from nonrepayment of advances to one of his corporations were proximately related to his separate business of selling timber. That ruling was based on a number of factors not present in the instant case. The taxpayer as an individual had been in the business of selling timber before the corporation involved (RushMore) was organized, and continued selling timber to his various corporations and other parties both during RushMore's short corporate life and thereafter. In the case at bar, taxpayer's money-lending activities were mainly confined to advances to Union Finance and its customers, and terminated when Union Finance went into receivership in 1961. As the Tax Court noted (I-R. 31): "There seems to be no contention that this private loan business existed prior to 1955 and Gross testified flatly that it did not continue after 1961."

There were other significant facts in Lundgreen which distinguish it from the instant case. It was stipulated in Lundgreen that the taxpayer did not organize RushMore with the intent of receiving dividends or selling the stock at a profit. And the taxpayer gave undisputed testimony that his purpose in forming RushMore was to realize gain through sales of timber to the corporation and receipt of a salary for his services to it.

On such a record, the Whipple decision was inapplicable since the evidence (particularly the stipulated facts) precluded any conclusion that the taxpayer made his advances to RushMore qua stockholder, to protect and enhance his investment.

C. The Tax Court correctly found that taxpayer's bad debt losses were not incurred in a separate business of promoting and financing incorporated and unincorporated enterprises

Seeking a further business context for his bad debt losses, taxpayer contends (Br. 23) that his losses were incurred in a separate business of promoting and financing business ventures.

However, the record shows that taxpayer made advances to only four enterprises other than Union Finance, and that he had an investment stake in each of these enterprises, as in Union Finance. (I-R. 34.) The Tax Court concluded (I-R. 33) that the advances to such enterprises, if not equity capital, were made to enhance or protect taxpayer's investments and (I-R. 34) to aid the businesses of those enterprises, and that such advances did not place him in a separate business of promoting and financing business ventures. These conclusions are supported and, indeed, required by the Supreme Court's recent decision in Whipple v. Commissioner, 373 U.S. 193.

In Whipple the taxpayer engaged in far more diversified and extensive activities in promoting business ventures than did the taxpayer in the instant case. The taxpayer in Whipple was an incorporator and stockholder at different times in at least

twenty different corporations. As to twelve of these corporations, he promoted them for a time and then sold his interests in them. He also bought and sold land, acquired and disposed of a restaurant and participated in several oil ventures. The Supreme Court held, nevertheless, that the foregoing activities on the part of the taxpayer, qua investor, did not constitute a separate business. The court held that (373 U.S., p. 202):

> Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself.

In so holding, the court acknowledged that an individual taxpayer might be in a separate trade or business of promoting corporations for a fee or commission, or of developing corporations as going businesses for sale to customers in the ordinary course. Neither situation being present, the court held that the taxpayer's losses from advanced to one of his corporations were losses from nonbusiness bad debts.

Similarly, in the case at bar, there is no evidence or contention that taxpayer was in the business of promoting corporations for a fee or commission in the ordinary course. The record shows only that taxpayer made advances to Union Finance and four other enterprises in which he had an investment stake. The Tax Court was amply warranted, then, in concluding (I-R. 33-34)

that such advances were made to enhance or protect taxpayer's investments and aid the businesses in which he was an investor--not loans in the course of a separate business of promoting and financing business enterprises.

D. The Tax Court correctly found that none of the bad debt losses were proximately related to the taxpayer's status as a salaried officer of Union Finance

Decisions of this Court and other appellate courts have held that a salaried corporate officer is in a separate trade or business of rendering services for pay, for the purposes of Section 166.[7] But those decisions have by no means treated salaried corporate officers as automatically entitled to business bad debt deductions with respect to advances to their corporations; they have recognized and applied the requirement that a bad debt loss must bear a proximate relation to the individual's trade or business in order to qualify as a fully-deductible business loss. Lundgreen v. Commissioner, 376 F. 2d 623; and e.g., Kelly v. Patterson, 331 F. 2d 753; Weddle v. Commissioner, 325 F. 2d 849 (C.A. 2d); Trent v. Commissioner, 271 F. 2d 669 (C.A. 2d). It is useful to consider circumstances in the foregoing decisions

7/ In Whipple, although the Supreme Court recognized by dicta that an individual may promote corporations for a fee or commission, or for sale in the ordinary course, it reserved judgment on the correctness of decisions holding that a salaried corporate executive is in a separate trade or business of rendering services for pay.

which impelled the courts to the conclusion that the requisite proximate relation was present.

Trent, the earliest of these decisions and a landmark case, involved a taxpayer who was employed by one of two affiliated corporations on certain express conditions, including the requirements that he purchase one-third of the stock of the other corporation and that he make loans to both companies until their financial condition improved. After making eleven loans to the corporations, taxpayer balked at making a further requested advance and was fired. The taxpayer claimed business bad debt losses from the nonrepayment of the loans. The Tax Court ruled that the loans, made for the undisputed purpose of protecting the taxpayer's employment, were not incident to a separate trade or business. The Second Circuit reversed and held that, under the circumstances, taxpayer's bad debt losses were proximately related to his separate trade or business of rendering services for pay and therefore fully deductible.

As noted, the taxpayer in Trent was a minority stockholder. In Whipple, the Supreme Court reserved judgment on the correctness of Trent, but pointed to the problem of proof in a case involving a larger stockholder (373 U.S., p. 204):

> Moreover there is no proof (which might be difficult to furnish where the taxpayer is a sole or dominant shareholder) that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee. Compare Trent v. Commissioner, supra. (Emphasis supplied.)

Shortly after Whipple was decided, the Second Circuit decided Weddle v. Commissioner, 325 F. 2d 849. There the taxpayer was controlling stockholder, president, general manager and a director of a corporation. As president and general manager she received a salary. She guaranteed loans to the corporation and, on its insolvency liquidation, paid the portion of the loans not covered by the corporate assets. She then claimed a business bad debt deduction for the amount so paid, invoking Trent. In the majority opinion the Second Circuit distinguished Trent as a case where there was no real dispute that the loans were made to protect the taxpayer's employment. And it agreed with the Tax Court that the taxpayer had failed to prove that protection of her employment had been a significant motivation for endorsing the notes. However, by way of caveat, the majority took the position that a corporate employee is also a controlling stockholder might be able to prove that protection of employment was a significant motivation, and that proof thereof (whether or not it was the primary motivation) would be sufficient to establish the requisite proximate relation of a bad debt loss to the taxpayer's business as employee. See also Millsap v. Commissioner (C.A. 8th), decided January 2, 1968. Ch Judge Lumbard, concurring in Weddle, took issue with the majority's significant motivation rationale, saying (p. 852):

> Where a corporate employee and stockholder makes loans to the corporation two fundamental motivations will inevitably be involved, that of protecting the taxpayer's investment in the corporation and that of protecting his salary interest. Unless the salary

> interest is so small as to be of negligible value its preservation will surely weigh in the mind of the taxpayer in advancing monies to the corporation. Consequently, to measure the proximateness of the relationship between the loan and the taxpayer's status as a corporate employee by asking whether the latter provides a "significant" -- although not the dominant -- motivation is to pose a question which invariably will be answered in the affirmative.

We submit that Judge Lumbard's reasoning is cogent and sound, and that the majority's significant motivation rationale trenches on the Supreme Court's decision in Whipple. The Fifth Circuit has ostensibly avoided taking sides in Kelly v. Patterson, 331 F. 2d 753, where it denied the business bad debt deduction claimed by a stockholder and salaried corporate employee with respect to loans he had made to his corporation. The court said (p. 757):

> Mr. Kelly was the controlling stockholder with a substantial investment in the corporation as compared to the salary received. The proof falls short of showing the loans to have been proximate to his business of being an employee of the corporation under either of the standards asserted by the Second Circuit in Weddle. What the proof does show, on the other hand, is that the loans were made as an investment or to protect an investment, and only indirectly to saving Mr. Kelly's job through saving his investment. This type situation falls under the investor doctrine of Whipple. Cf. Byck, supra.

The foregoing reasoning is actually quite close to Judge Lumbard's views; the majority in Weddle might well reject it as another way of formulating a primary motivation test in terms of direct and indirect purposes.

Thereafter, in Lundgren, this Court held that the taxpayer's advances to RushMore were proximately related to his separate trade

or business of rendering services to the corporation as well as to his separate business of selling timber. That ruling was supported by two considerations. First, as noted above, stipulated facts and undisputed testimony required the conclusion that the taxpayer did not organize RushMore with the intent of receiving dividends or selling stock at a profit, but for the purpose of realizing gain from the sale of timber to the corporation and the receipt of a salary for his services to it. Second, the record showed that the necessary financing of RushMore was provided by the SBA on the express condition that the taxpayer make the personal advances involved. On this record, the court held that taxpayer made the advances to protect his employment and contemplated salary as well as to further his separate business of selling timber.

In the instant case, unlike Lundgren and Trent, taxpayer's advances to Union Finance and its customers were wholly voluntary -- not a condition of his employment. Nor is there any evidence here that, as in Lundgren, the taxpayer made his advances to protect his employment. Moreover, it is not simply a matter here -- as in Weddle and Kelly -- of a failure on the taxpayer's part to prove that his losses were incurred in a separate business; the record affirmatively shows, as demonstrated above, that taxpayer made his advances to aid the business of Union Finance and protect his investment. If confirmation of this be needed, consider the following testimony of the taxpayer (II-R. 93):

Q. Now, these advances, the money that you and your wife advanced to Union Finance Company, is it my understanding that they gave it a broader working capital base?

A. We advanced money for two reasons. For the interest we received, No. 1; and No. 2, by having the money we were able to borrow additional funds for the benefit of the finance company.

Q. This did broaden the base of your ability to get money from the bank, is that it?

A. Yes, there were two purposes. One was investment.

In short, the taxpayer had no thought of protecting his employment. And as for "the interest we received," it has already been noted above that, with negligible exceptions, only the advances to the corporation itself were interest-bearing; and that such interest as the taxpayers received was in relatively small amounts, far exceeded by the bad debt deductions claimed.

In Whipple v. Commissioner, 373 U.S. 193, the Supreme Court said that it was unwilling to disturb the Tax Court's determinations that the taxpayer was not engaged in the business of money-lending, or of financing corporations, since (373 U.S., p. 204) "we cannot say they are clearly erroneous. See Commissioner v. Duberstein, 363 U.S. 278, 289-291." This Court, as it stated in Hirsch v. Commissioner, 315 F. 2d 731, has repeatedly declared its adherence to this standard of review. In the instant case the Tax Court's findings are not only free of clear error but are amply supported by the record, and the Tax Court has applied the proper criteria to the facts as found.

For the reasons stated above, the decision of the Tax Court is correct and, accordingly, should be affirmed.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this _____ day of _____, 1968, in an envelope, with postage prepaid, properly addressed to him as follows:

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